Austrian Economics

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Austrian economics, so named for its country of origin, is distinguished by its methodological precepts and by its theories of capital, money, and the business cycle. Carl Menger (1840–1926), who taught at the University of Vienna, is the acknowledged founder of this school of thought. Menger's writings, particularly his *Principles of Economics* (1871) and his *Investigations into the Method of the Social Sciences* (1883), set out the principles and methods that guided the development of a worldwide Austrian tradition.

Menger rejected the German historicism of Wilhelm Roscher (1817–1894), which offered an inductive approach to economic understanding; and he deviated markedly from the eighteenth-century British classicism of David Ricardo (1772–1823) and John Stuart Mill (1806–1873), which featured long-run relationships among the different economic classes of people (workers, capitalists, and landlords). Menger's theory of economic institutions does bear a striking resemblance to the invisible-hand theorizing of Adam Smith (1723–1790). However, given Smith's cost-based theory of value, the appropriateness of linking Menger and his followers to the reputed father of economic science is a contentious issue among contemporary Austrian economists.

Menger focused on the individual market participant and on his or her choices as governed by perceived needs and wants. This general approach to economics was termed "methodological individualism" by the sociologist Max Weber (1864–1920). Menger's notion of economic value derives from the purposes of the individuals doing the valuing rather than from the qualities of the objectively defined goods being valued. Menger's value theory, termed "methodological subjectivism" and now embedded (though not consistently) in modern economics, stood in contrast to Marxism's labor theory of value and classicism's cost-of-production theory of value.

Methodological individualism and the closely related methodological subjectivism allow for a straightforward accounting of the gains from trade. Individuals value various goods differently, such that trading goods allows both traders to gain. Direct exchange (goods for goods) leads quite naturally to indirect exchange (goods for more-easily-tradable goods for actually-sought-after goods). The more-easily-tradable goods are called media of exchange. Over time, the practice of indirect exchange gives rise to a *most* commonly accepted medium of exchange This is Menger's theory of money—with early monies taking the forms of salt or cattle and later monies, silver or gold. (The fact that modern paper money is a result of governmental institutions overriding the would-be choices of market participants is seen as supporting Menger's theory.)

Whether exchange is direct or indirect, market values never pertain to the whole of the supply, such as the diamond supply or the water supply. Rather, they pertain to the smallest quantities of the goods subject to potential trades, that is, the marginal unit. Because of relative scarcities, the value of the marginal unit of diamonds exceeds the value of the marginal unit of water—despite water's being the more useful of the two goods. This is Menger's resolution of the so-called diamond-water paradox, which was identified by Adam Smith (who distinguished value in use from value in exchange) but not satisfactorily resolved until the "Marginalist Revolution" of the 1870s. Menger was one of three revolutionists, the others being British economist William Stanley Jevons (1835–1882) and French economist Leon Walras (1834–1910). The latter two formulated the issues mathematically by writing the equations for total and marginal utility (Jevons) and for the equilibrium relationships among all the prices in a frictionless market economy (Walras).

Historians of economic thought sometimes see the Austrian theory as applying only to the demand side of the market—with supply and demand finally being juxtaposed by Alfred Marshall (1842–1924), who drew supply

from the classicists and demand from the marginal revolutionists. But Menger applied his value theory to the means of production as well as to the ends. Consumption goods were designated as "goods of the first order." Markets for goods of the second, third, and higher orders guide the time-consuming production activities that proceed from the highest to the lowest order. This reckoning, together with the concept of opportunity costs introduced by Friedrich von Wieser (1851–1926), established the Austrian supply-side relationships.

Eugen von Böhm-Bawerk (1851–1914) developed Menger's conception of the production process into a theory that he explicated in *Capital and Interest* vol. 2, 1889). The rate of interest governs the extent to which resources can profitably be tied up in the production process: The lower the interest rate, the more roundabout, or time-consuming, the production process. Unfortunately, Böhm-Bawerk's use of a crude arithmetic reckoning of roundaboutness (the average period of production) diverted attention from the otherwise Mengerian construction and played into the hands of critics who questioned the relevance of such a metric.

In his *Theory of Money and Credit* (1912) Ludwig von Mises (1881–1973) used marginalist thinking to account for the value of money and, drawing on Böhm-Bawerk's capital theory, set out a theory of the business cycle. Interest rates held artificially low by central banks stimulate investment and cause production processes to be unduly roundabout. In the absence of sufficient resources to complete all of the production processes, the boom eventually gives way to a bust. In essence, the boom-bust cycle is an instance of economic discoordination attributable to an interest rate that does not accurately reflect the valuations and choices of market participants.

Mises systematized Austrian economics in his *Human Action* (1949), calling its method praxeology, which literally means "action logic." He distinguished between economics and history, denying that there is a unilateral testing of economic theory with historical data but recognizing that the two disciplines are essential complements in our understanding of real-world economies. Mises's praxeology, an exclusively deductive system of logic based on self-evident axioms (e.g., human action is purposeful) stands in contrast to Milton Friedman's "Methodology of Politive Economics" (1953), according to which contrary-to-fact assumptions can be used in the formulation of theory, which can then be accepted or rejected on the basis of empirical evaluation. In Misis's hard-drawn Austrianism, empirical studies serve to identify cases or episodes in which a particularly theory is applicable.

In his *Prices and Production* (1935), Friedrich A. Hayek (1899–1992) developed the business cycle theory, offering this means-ends theorizing about booms and busts as an alternative to the circular-flow theorizing of John Maynard Keynes (1883–1946). By many accounts, Hayek's theory lost out to Keynes's primarily because of its lack of politically attractive policy prescriptions. Israel M. Kirzner (b. 1930) developed the essential entrepreneurial aspects of the Austrian theory and, along with Hayek, offered a market-as-a-process view that stands in contrast with the more conventional mathematics of market equilibria. In both microeconomic and macroeconomic contexts, the Austrians have argued that governments are ill advised to override market forces with central planning or to supplement those forces with economic stimulants. The policy prescription of *laissez-faire* is emphasized by Murray Rothbard (1826–1995) in his *Man, Economy, and State* (1962).

Through his introduction and selection of articles, Israel Kirzner offers, as an Austrian sampler, a three-volume *Classics in Austrian Economics* (1994). Dating from the mid-1970s, numerous books and articles have made Austrian economics a living tradition. Some developments and extensions are intended to compete with modern mainstream thinking; others to reconcile with it. In the contemporary world of economics, the Austrian principles of microeconomics (the subjectivity of value and opportunity costs) are widely accepted, although they are often observed in the breach because of considerations of mathematical tractability and data availability. By contrast, Austrian macroeconomics, which is rooted in capital theory and focuses on the allocation of resources over time, has been neither widely accepted nor well understood. Dating from the Keynesian revolution, capital theory is seen as foundational for theories of economic growth but as largely irrelevant for macroeconomics, which deals instead with overall levels of output and inflation.

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